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SUBJECT: BUDGET 2007 ITALY: TIGHTWIRE ACT BEGINS WITH RELEASE OF DPEF PREVIEW

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¶1. Summary: The public release of Italy's four-year financial plan, the DPEF, officially opens Italy's 2007 budget process. Prime Minister Prodi's coalition will formally present its draft 2007 budget by end-September. Parliament must approve the final budget by the end of December. To avoid creating tension within the governing coalition, the DPEF only makes vague references to budget cuts and tax increases. Jockeying among ruling coalition and opposition politicians over the budget has already begun in the media. The 2007 budget could serve as one important issue on whether Prodi's fragile coalition will last into next year. End summary.

DPEF Background

¶2. Italy's four-year budget "preview," the "Documento di Programmazione Economica e Finanziaria" (DPEF), covers the period 2007-2011. (Note: Italy's fiscal year is the same as its calendar year. End note.) This year's DPEF was presented July 7, along with a supplemental deficit reduction package to close the 2006 budget gap and a competition/liberalization package affecting, inter alia, insurance policies, taxi licenses, and retail operations. The DPEF was reviewed by Parliament without a final vote. This year's DPEF sets budgetary guidelines through 2011, projecting economic performance and identifying budgetary goals. While not binding, the DPEF serves as a preview of the 2007 budget that Prodi's coalition will present to Parliament in late September. Leading coalition and opposition politicians have already begun to argue publicly in the press about what needs to be done with the budget to improve Italy's financial situation and prospects for economic growth.

DPEF Budget Targets

¶3. The stated goals of this year's DPEF are to: a) reduce the Italian public debt/GDP ratio (currently at 108 percent) to 99.7 percent by 2011; b) return the budget deficit/GDP ratio to below the EU-mandated three percent ceiling by 2007 and to 0.1 percent of GDP by 2011; and c) increase the primary surplus (budget deficit less interest payments as a percentage of GDP) by 2011. (Note: A

condition of Italy's entry into the European Monetary Union was a primary surplus of five percent. End note.) Implicit in the DPEF is that Prodi's ruling coalition lasts until 2011.

¶4. The DPEF states that Italian public accounts are "potentially unsustainable," due to the large budget deficit, a primary surplus hovering near zero, and rising public debt. The DPEF recognizes that Italy has not met its Eurozone commitments on public debt and budget deficit levels. (Note: The European Commission has warned Italy that it must reduce its current 4.1 percent budget deficit/GDP measure to 3.0 percent in 2007. End note.)

Suggested Budget Measures; Projections

¶5. The DPEF projects a budget deficit of 4.0 percent this year -- slightly above the 3.8 percent target of the 2006 budget (reftel) -- and a budget deficit of 2.8 percent of GDP in 2007. While its aims are ambitious, the DPEF's contents are vague. The DPEF anticipates unspecified budget cuts and tax increases by 35 billion euro in 2007 (equal to 2.3 percent of GDP) to meet EU budget compliance commitments, an economic stimulus package, and social programs. The DPEF does not offer concrete suggestions for lowering public debt and decreasing the budget deficit to improve public finances -- probably to avoid creating too much tension within the governing coalition. The DPEF also does not include concrete proposals to stimulate GDP growth and improve Italy's competition in international markets. The document mentions unspecified plans to implement structural measures equal to half a percentage point of GDP each year in 2008-2010 through unspecified further tax increases and spending cuts. The DPEF also includes a macroeconomic assumption/target of 1.5 percent GDP growth in 2006, followed by 1.2 percent growth in 2007.

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Central Bank Supports Calls for Tougher Spending Cuts.
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¶6. In July 17 testimony before the Senate and Chamber Budget Committees, Central Bank Governor Draghi offered his support to this year's DPEF. However, Draghi suggested the government should be more aggressive in cutting pension and local government expenditures and increase the retirement age to make Italy's pension system sustainable. Draghi noted that both measures would help ensure that Italy remains competitive internationally.

COMMENT

¶7. Prodi and Finance Minister Padoa-Schioppa will have a difficult task convincing their coalition partners, constituents, and the opposition to take the steps necessary to return Italy to financial stability and economic growth. Since a significant increase in economic growth is not forecast in the DPEF, tax increases and/or spending cuts are necessary to meet the DPEF's goals. However, Prodi and Padoa-Schioppa will find it tough to sell increased taxes or spending cuts to skeptical coalition allies. The opposition will also be extremely difficult to engage, and has already declared it will oppose any deficit reduction measures that "penalize" their constituencies. The opposition would like nothing more than to see the collapse of Prodi's coalition, and will likely try to use the 2007 budget to bring about this collapse.

¶8. Another last-minute, surprise challenge to Prodi's DPEF is a 12.3 percent (20 billion euro) windfall in tax revenue in the first half of 2006. This gain is largely due to increased Value Added Tax, personal and corporate income tax revenues. This bonus, however, has already fueled speculation and political demands that 2007 budget cuts are not necessary. Both Prodi and Padoa-Schioppa have had to make it clear this revenue increase was already assumed in the DPEF and that it will not impact the 2007 deficit reduction package (which, of course, includes budget cuts). Nonetheless,

coalition or opposition politicians will still try to use this windfall to force Prodi into watering down proposed spending cuts and/or tax increases. End comment.

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